**1-1 What is a *standard of living?* What factors affect the quality of life?**

*Standard of living,* which varies from person to person, represents the necessities, comforts, and luxuries enjoyed by a person. It is reflected in the material items a person owns, as well as the costs and types of expenditures normally made for goods and services.

Although many factors such as geographic location, public facilities, local costs of living, pollution, traffic, and population density affect one’s quality of life, the main determinant of quality of life is believed to be wealth.

**1-2 Are consumption patterns related to quality of life? Explain.**

Generally,consumption patternsare related to quality of life, which depends on a person’s socioeconomic strata. This implies that wealthy persons, who are likely to consume non-necessity items, quite often live higher quality lives than persons whose wealth permits only consumption of necessities.

**1-3 What is *average propensity to consume?* Is it possible for two people with very different incomes to have the same average propensity to consume? Why?**

The *average propensity to consume* is the percentage of each dollar of a person’s income that is spent (rather than saved), on average, for current needs rather than savings. Yes, it is quite possible to find two persons with significantly different incomes with the same average propensity to consume. Many people will increase their level of consumption as their incomes rise, i.e., buy a nicer home or a newer car. Thus, even though they may have more money, they may still consume the same percentage (or more) of their incomes as before.

**1-4 Discuss the various forms in which wealth can be accumulated.**

An individual’s *wealth* is the accumulated value of all items he or she owns. People accumulate wealth as either financial assets or tangible assets. *Financial assets* areintangible assets such as savings accounts or securities, such as stocks, bonds and mutual funds. Financial assets are expected to provide the investor with interest, dividends, or appreciated value. *Tangible assets* are physical items, such as real estate, automobiles, artwork, and jewelry. Such items can be held for either consumption or investment purposes or both.

**1-5** **What is the role of money in setting financial goals? What is the relationship of money to utility?**

*Money* is the exchange medium used as the measure of value in our economy. Money provides the standard unit of exchange (in the case of the U.S., the dollar) by which specific personal financial plans—and progress with respect to these plans—can be measured. Money is therefore the key consideration in establishing financial plans. *Utility* refers to the amount of satisfaction derived from purchasing certain types or quantities of goods and services. Since money is used to purchase these goods and services, it is generally believed that greater wealth (money) permits the purchase of more and better goods and services that in turn result in greater utility (satisfaction).

**1-6 Explain why financial plans must be psychologically as well as economically sound. What is the best way to resolve money disputes in a relationship?**

Money is not only an *economic* concept; it is also a *psychological* one that is linked through emotion and personality. Each person has a unique personality and emotional makeup that determines the importance and role of money in his or her life, as well as one’s particular money management style. Personal values also affect one’s attitudes to money. Money is a primary motivator of personal behavior and has a strong impact on self-image. To some, money is of primary importance, and accumulation of wealth is a dominant goal. For others, money may be less important than lifestyle considerations. Therefore, every financial plan must be developed with a view towards the wants, needs, and financial resources of the individual and must also realistically consider his or her personality, values, and money emotions.

Money is frequently a source of conflict in *relationships*, often because the persons involved aren’t comfortable discussing this emotion-laden topic. Each person may have different financial goals and personal values, leading to different opinions on how to spend/save/invest the family’s money. To avoid arguments and resolve conflicts, it is essential to first become aware of each person’s attitude toward money and his or her money management style, keep the lines of communication open, and be willing to listen and to compromise. It is possible to accommodate various money management styles within a relationship or family by establishing personal financial plans that take individual needs into account. Some families are able to avoid conflict by establishing separate accounts, such as yours, mine and household, with a set amount allocated to each account each pay period. This way, no one feels deprived, and enough has been set aside to pay the bills and to meet common financial goals.

**1-7 Explain why it is important to set realistically attainable financial goals. Select one of your personal financial goals and develop a brief financial plan for achieving it.**

Realistic goals are set with a specific focus and a reasonable time frame to achieve results. It is important to set realistically attainable financial goals because they form the basis upon which our financial plans are established. If goals are little more than “pipe dreams,” then the integrity of the financial plans would be suspect as well

Students’ descriptions of the steps to achieve a specific goal will, of course, vary. They should follow the general guidelines in the chapter: define financial goals, develop financial plans and strategies to achieve goals, implement financial plans and strategies, periodically develop and implement budgets to monitor and control progress toward goals, use financial statements to evaluate results of plans and budgets, and redefine goals and revise plans as personal circumstances change.

**1-8** **Distinguish between long-term, intermediate, and short-term financial goals. Give examples of each**.

Individual time horizons can vary, but in general individuals would expect to achieve their *short-term* financial goals in a year or less, *intermediate-term* goals in the next 2-5 years, and *long-term* financial goals in more than 5 years. Refer to Worksheet 1.1 for examples of financial goals.

In making personal financial goals, individuals must first carefully consider their current financial situation and then give themselves a pathway to reach their future goals. People in the early stages of their financial planning life cycle may need more time to accomplish long-term goals than those who are already established in their careers and may also need to give themselves more flexibility with their goal dates.

**1-9** **What types of financial planning concerns does a complete set of financial plans cover?**

Financial plans provide the roadmap for achieving your financial goals. The six-step financial planning process (introduced in Exhibit 1.3) results in separate yet interrelated components covering all the important financial elements in your life. Some elements deal with the more immediate aspects of money management, such as preparing a budget to help manage spending. Others focus on acquiring major assets, controlling borrowing, reducing financial risk, providing for emergency funds and future wealth accumulation, taking advantage of and managing employer-sponsored benefits, deferring and minimizing taxes, providing for financial security when you stop working, and ensuring an orderly and cost effective transfer of assets to your heirs.

**1-10** **Discuss the relationship of life-cycle considerations to personal financial planning. What are some factors to consider when revising financial plans to reflect changes in the life cycle?**

Personal needs and goals change as you move through different *stages of your life*. So, too, do financial goals and plans, because they are directly influenced by personal needs. When your personal circumstances change, your goals must reflect the new situation. Factors such as job changes, a car accident, marriage, divorce, birth of children or the need to care for elderly relatives must be considered in revising financial plans.

**1-11 Chad Jackson’s investments over the past several years have not lived up to his full return expectations. He is not particularly concerned, however, because his return is only about 2 percentage points below his expectations. Do you have any advice for Chad?**

The loss of *two percentage points* on investment returns is anything but inconsequential, particularly if the loss occurs annually over a period of several years. For example, if Chad had invested $1,000 at an 8 percent return and subsequently had invested all earnings from the initial investment at 8 percent, in 40 years he would have accumulated $21,725 from the initial $1,000 investment. If, on the other hand, he had earned a 10 percent return on the same investment, he would have accumulated $45,259 in 40 years—more than double his return at 8 percent! Clearly, two percentage points over time can make a significant difference! Calculate various rates of return on a $1,000 investment to see that for every 2 percent increase in return, your investment results will more than double over a 40-year period.

By carefully considering his investment and banking choices, it is likely that Chad would be able to get a 2 percent greater rate of return without taking on additional risk. This can be done both by choosing investments and bank accounts that hold down expenses, as well as by finding investments of the same type that have performed better.

1-12 **Describe employee benefit and tax planning. How do they fit into the financial planning framework?**

*Employee benefits,* such as insurance (life, health, and disability) and pension and other types of retirement plans, will affect your personal financial planning. You must evaluate these benefits so that you have the necessary insurance protection and retirement funds. If your employer’s benefits fall short of your needs, you must supplement them. Therefore, employee benefits must be coordinated with and integrated into other insurance and retirement plans.

*Tax planning* involves looking at an individual’s current and projected earnings and developing strategies that will defer and/or minimize taxes. For income tax purposes, income may be classified as active income, passive income, or portfolio income. While most income is currently subject to income taxes, some may be tax free or tax deferred. Tax planning considers all these dimensions and more. Tax planning is an important element of financial planning because it guides the selection of investment vehicles and the form in which returns are to be received. This means that it is closely tied to investment plans and often dictates certain investment strategies.

**1-13 “There’s no sense in worrying about retirement until you reach middle age.” Discuss this point of view.**

This statement reflects a very limited and too often expressed point of view. Due to the inconsistencies and vagaries of our economic system—and of life itself!—the goals of and plans for retirement should be established early in life. If retirement goals are incorporated into an individual’s financial planning objectives, short- and long-term financial plans can be coordinated. Thus, financial plans can guide present actions not only to maximize current wealth and/or utility, but also to provide for the successful fulfillment of retirement goals. Furthermore, if retirement is desired earlier than anticipated, the plans may still permit the fulfillment of retirement goals.

**1-14 Discuss briefly how the following situations affect personal financial planning:**

1. **Being part of a dual-income couple**

Couples should discuss their money attitudes and financial goals and decide how to manage joint financial affairs *before* they get married. Take an inventory of your financial assets and liabilities, including savings and checking accounts; credit card accounts and outstanding bills; auto, health, and life insurance policies; and investment portfolios. You may want to eliminate some credit cards. Too many cards can hurt your credit rating, and most people need only one or two. Each partner should have a card in his or her name to establish a credit record. Compare employee benefit plans to figure out the lowest-cost source of health insurance coverage, and coordinate other benefits. Change the beneficiary on your life insurance policies as desired. Adjust withholding amounts as necessary based on your new filing category.

1. **Major life changes, such as marriage or divorce**

Major life changes such as marriage and divorce:

*Marriage.* Finances must be merged and there may be a need for life insurance.

*Divorce.* Financial plans based on two incomes are no longer applicable. Revised plans must reflect any property settlements, alimony, and/or child support.

1. **Death of a spouse**

The surviving spouse is typically faced with decisions on how to receive and invest life insurance proceeds and manage other assets. In families where the deceased made most of the financial decisions with little or no involvement of the surviving spouse, the survivor may be overwhelmed by the need to take on financial responsibilities. Advance planning can minimize many of these problems.

**1-15 What is a *professional financial planner?* Does it make any difference whether the financial planner earns money from commissions made on products sold as opposed to the fees he or she charges?**

Unlike accounting and law, the field professional financial planning field is largely unregulated, and almost anyone can call themselves a *professional financial planner.* Most financial planners are honest and reputable, but there have been cases of fraudulent practice. So, it’s critical to thoroughly check out a potential financial advisor–preferably interview two or three.

Most financial planners fall into one of two categories based on how they are paid: commissions or fees. *Commission-based planners* earn commissions on the financial products they sell, whereas *fee-only planners* charge fees based on the complexity of the plan they prepare. Many financial planners take a hybrid approach and charge fees and collect commissions on products they sell, offering lower fees if you make product transactions through them.

The way a planner is paid—commissions, fees, or both—should be one of your major concerns. Obviously, you need to be aware of potential conflicts of interest when using a planner with ties to a brokerage firm, insurance company, or bank. Many planners now provide clients with disclosure forms outlining fees and commissions or various transaction costs.

**1-16 Discuss the following statement: “The interactions among government, business, and consumers determine the environment in which personal financial plans must be made.”**

Government, businesses, and consumers are the three major participants in the economic system. *Government* provides the structure within which businesses and consumers function. In addition, it provides a number of essential services that generally improve the quality of the society in which we live. To create this structure, various regulations are set forth, and to support its activities and provision of essential services, taxes are levied. These activities tend to constrain businesses and consumers.

*Businesses* provide goods and services for consumers and receive money payments in return. They also employ certain inputs in producing and selling goods and services. In exchange they pay wages, rents, interest, and profit. Businesses are a key component in the circular flow of income that sustains our economy. They create the competitive environment in which consumers select from many different types of goods and services. By understanding the role and actions of businesses on the cost and availability of goods and services, consumers can better function in the economic environment and, in turn, implement more efficient personal wealth maximizing financial plans.

*Consumers* are the focal point of the personal finance environment. Their choices ultimately determine the kinds of goods and services that businesses will provide. Also, consumer spending and saving decisions directly affect the present and future circular flows of income. Consumers must; however, operate in the financial environment created by the actions of government and business. Consumers may affect change in this environment through their elected officials, purchasing decisions and/or advocacy groups. Yet, basically, change occurs slowly and tediously, often with less than favorable results. Thus, consumers should attempt to optimize their financial plans within the existing financial environment.

**1-17 What are the stages of an economic cycle? Explain their significance for your personal finances**.

The stages of the economic cycles are *expansion, peak, contraction*, and *trough.* Each of these stages relates to real gross domestic product (GDP), which is an important indicator of economic activity.The stronger the economy, the higher the levels of real GDP and employment*.* During an *expansion,* employment is high, the economy is active and growing, and prices tend to rise. During an expansion, real GDP increases until it hits a peak, which usually signals the end of the expansion and the beginning of a contraction. During a contraction, real GDP falls into a trough, which is the end of a contraction and the beginning of an expansion. An understanding of these four basic stages, coupled with knowledge of the stage in which the economy is presently operating, should permit individuals to adjust and implement financial actions in order to efficiently and successfully achieve their personal financial goals.

**1-18 What is *inflation*, and why should it be a concern in financial planning?**

*Inflation* is a state of the economy in which the general price level is rising. It is important in financial planning because it affects what we pay for goods and services; it impacts how much we earn on our jobs; it directly affects interest rates and, therefore, it affects such things as mortgage and car loan payments. The most common measure of inflation is the *consumer price index,* which is based on the changes in the cost of a typical “market basket” of consumer goods and services. This can be used to compare changes in the cost of living over time for the typical family. Inflation is measured by the percentage change in the consumer price index from one time period to another, so that as the CPI rises, the cost of living also increases.

**1-19.** **“All people who have equivalent formal education earn similar incomes.” Do you agree or disagree with this statement? Explain your position.**

Disagree. Although higher levels of education may result in higher levels of income, this does not mean that everyone with a given level of education will achieve a specified level of income. Factors such as age, marital status, geographical location, and career choice also impact a person’s level of income. A number of other factors, such as the degree of personal motivation and the methods by which one utilizes his or her formal education, can also affect one’s income level.

**1-20** **Discuss the need for career planning throughout the life cycle and its relationship to financial planning. What are some of your own personal career goals?**

*Career planning* is a critical part of the life cycle of the personal financial planning process. The choice of a career affects the amount you earn. By setting both short- and long-term career goals, you can incorporate them into your financial plans. For example, if you need additional education and/or other training for a particular job, you may include a savings plan to obtain the needed funds. You should reevaluate your career decision periodically to see if it still meets your personal and financial goals. Other important considerations with regard to a specific job (and company) include the earnings potential, advancement opportunities, and benefits, plus how well the job fits your lifestyle and values. In today’s rapidly changing job environment, you should expect to change careers several times. It is important to keep up with developments in your industry, acquire a broad base of experience, and continue to learn new skills, both general and technical.

Each student will, of course, have a different list of personal career goals based upon his or her career orientation and goals. However, responses should include discussion of personal financial planning and associated career planning goals and how a career choice would best fulfill quality of life, standard of living, and wealth maximization objectives. Goals might include getting a bachelor’s, master’s or other degree, working in a specific industry, owning one’s own business, finding a job in a different area of the country or overseas, achieving a desired salary and/or responsibility level by a certain age, or finding a job that meets lifestyle needs.